SOAH DOCKET NO. 582-11-1468
TCEQ DOCKET NO. 2010-1841-UCR

APPLICATION OF SJWTX, INC, DBA CANYON LAKE WATER SERVICE COMPANY TO CHANGE WATER RATES; CCN NO. 10692; IN COMAL AND BLANCO COUNTIES	§ § § § §	**BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS**

CEWR'S REPLIES TO EXCEPTIONS TO THE PROPOSAL FOR DECISION

TO THE HONORABLE COMMISSIONERS OF THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY:

The Coalition for Equitable Water Rates ("CEWR") respectfully submits its Replies to the Exceptions to the Proposal for Decision, and in support of its exceptions would show the following:

I. Reply to CLWSC's Exceptions

The ALJs have done a commendable job of bringing order out of an unnecessarily complicated rate application and a tortuous hearing process (complications created by CLWSC and not by CEWR). The parties advocated their positions strongly before the ALJs (who were, perhaps, somewhat limited by a lack of solid Commission precedent), and aside from the issues raised in CEWR's Exceptions, the findings and conclusions in the PFD are more than amply supported by law and the evidence in the record.

Despite the thorough and well-reasoned analysis provided by the ALJs, CLWSC continues to disregard the evidence in the record and the law in it its attempt to persuade the Commission to allow CLWSC to raise its rates beyond an amount that is reasonable. CLWSC's 64 pages of exceptions are a rehash of the hundreds of pages of closing arguments and replies previously filed with the ALJs. Rather than explaining how the findings and conclusions in the PFD are not supported by the law or evidence, CLWSC's exceptions merely invite the Commission to re-decide the issues without the benefit of having actually participated in the hearing. The Commission should resist this invitation. The ALJs heard the witness' actual testimony, and only the ALJs can assess the appropriate amount of weight to give to that testimony. The ALJs spent countless hours, at hearing and post-hearing, immersing themselves in the complex area of rate regulation. Without the benefit of this thorough understanding of the law and the facts, the Commission must be careful when making changes to the PFD because of the interrelated nature of the findings.

CLWSC's exceptions are based on the premise that the rate recommended by the PFD will "harm CLWSC's financial integrity and result in a confiscatory rate order,"[1] and that the proposed findings and conclusions, if adopted, would discourage the consolidation of smaller utilities.[2] Nothing in the record supports either of CLWSC's exaggerated claims. There is no evidence in the record that CLWSC's financial integrity will be harmed by the rates recommended by the PFD. The only testimony that comes close is CLWSC's conclusory statements that it was operating at loss under its previous rates.[3] The PFD recommends a rate increase, and the recommended rates are only slightly lower than the interim rates that CLWSC has been charging since October 27, 2010. At no time during those two years has CLWSC approached the Commission for emergency relief to preserve its financial integrity. To the contrary, during the period CLWSC acquired four water systems from Bexar Metropolitan Water District. It seems inconceivable that a failing utility would have the financial wherewithal to acquire four water systems.

As to dampening consolidation, the evidence in the record shows that since purchasing the assets of the WSC, CLWSC purchased the following water systems: two public water systems from Emerald Valley Independent Aquatic Network, Ltd.; four PWSs from Rancho Del Lago, Inc., all assets of the North Point Homeowners Water Supply Corporation; Comal County assets of the Bexar Metropolitan Water District, and the assets of the City of Bulverde.[4] All of these acquisitions were made during the time that CLWSC claims that it was operating at a loss under its prior rates. Based on CLWSC's actions, there does not appear to be a direct link between rates and consolidation.

CLWSC's theme of imminent financial doom is just a ploy to extract concessions from the Commission, such as good cause exceptions and the bending of existing Commission rules and policies. The evidence in record shows that the rates recommended by the PFD (and even the rates recommended by CEWR) will be more than sufficient to permit CLWSC a reasonable opportunity to earn a reasonable return on its invested capital over and above its reasonable and

[1] CLWSC's Exceptions, p. 13.
[2] CLWSC's Exceptions, p. 38.
[3] Jensen Direct, p. 17-18.
[4] PFD, p. 5.

necessary operating expenses, and preserve the financial integrity of the utility.[5] The Commission should disregard the entirety of CLWSC's exceptions.

A. Rate of Return

The rate of return contained in the PFD provides CLWSC with more than a reasonable return on its invested capital. The arguments made by CLWSC are the same arguments that CLWSC unsuccessfully made to the ALJs. CLWSC offers nothing new to cause the Commission to reverse the reasoned decision of the ALJs.

1. Intercompany Loan

CLWSC complains that the ALJs mistakenly included a low interest rate loan as debt capital in the determination of the appropriate rate of return to apply. The facts on this issue are clear. CLWSC's intercompany loan from its parent is a loan and not equity. CLWSC is under a legal obligation to repay the debt, and the loan was reported as such on the books of both CLWSC and SJW Corp.[6] CLWSC has made payments on the loan at various times since the initial disbursement, and SJW Corp has been charging interest for the use of its money.[7] If this investment was equity and not debt, these payments would be dividends and no interest would be charged. If SJW Corp wanted to convert this loan to equity, it could have done so before the end of the test year. It did not do so. The loan should also not be viewed as short-term debt because the debt has remained outstanding since at least May 1, 2007.[8] Moreover, Commission rules regarding cost of capital make no distinction between long-term or short-term debt.[9] Finally, as recognized by the ALJs, the listing of the debt, as debt, on the company's financial statements confirms the debt is debt.[10]

CLWSC also asks the Commission to take the extraordinary step of artificially adjusting CLWSC debt/equity ratio to some "ideal" debt/equity balance. CLWSC has not shown that such extraordinary relief is needed to preserve its financial integrity. CLWSC offered no evidence regarding such a need. Therefore, the Commission should use CLWSC's actual debt/equity ratio. If CLWSC want to change this ratio in the future by converting the loan to equity, it is free to do so, provided that it complies with all relevant and applicable security laws.

[5] Tex. Water Code § 13.183(a).
[6] Tr. p. 1355/18-25.
[7] ED Ex. DL-42 (CLWSC405192-194).
[8] *Id.*
[9] 30 TAC §291.31(c)(1)(c)(i).
[10] PFD, p. 84.

Essentially, CLWSC is arguing that its shareholders alone should be allowed to benefit from this "below-market" loan. In our regulatory scheme, we want utilities to be efficient. We want them to buy goods and services at below-market prices. When they do so, both the shareholders as well as the ratepayers should share these benefits. CLWSC should be lauded for obtaining a loan with an interest rate of 2.25%, but it should not be allowed to set its rates as if the loan had a higher interest rate. The Commission should not change the ALJs findings and conclusions on the basis of CLWSC's exception.

2. ROR Worksheet

CLWSC objects to the ALJs decision to use the Executive Director's rate of return worksheet as the basis for establishing CLWSC's return on equity. Again, the ALJs' analysis of this issue is thorough and balanced. The Commission should remember that the ALJs should be allowed to judge the credibility of the expert witnesses tendered by the parties and the appropriate weight to be given to the expert's testimony.

CLWSC did not complete the rate of return worksheet as part of its application. Apparently, CLWSC believed that it could ignore portions of the Executive Director's application form. Instead, CLWSC requested a generic 12% return. The ALJ's decided that CLWSC's return on equity should be set at 10.88%[11] based on the application of the Executive Director's rate of return worksheet. The evidence in the record shows that the rate of return worksheet is designed to generate an acceptable return on equity number for any investor owned utility.[12]

CLWSC offered the expert testimony of Mr. Gregory E. Scheig, (CPA/ABV/CFF, CFA), who criticized the worksheet on a number of grounds. As the ALJs concluded, Mr. Scheig's attacks on the worksheet were unpersuasive given his lack of understanding of the statutory and regulatory standards for determining return under Texas law.[13] As he admitted on cross examination, he did not know whether the factors that the Commission looks at in setting return on equity were consistent with the factors that he used in making his recommendation.[14]

Moving beyond the worksheet, the return on equity recommended by the PFD should not adversely affect CLWSC's ability to attract capital. As clearly stated by CLWSC's expert, Mr.

[11] This is 1% greater than the rate recommended by the Executive Director and CEWR.
[12] ED Ex. DL-01, p. 23-24; ED Ex. DL-30.
[13] PFD, p. 89.
[14] Tr. p. 875-876.

Scheig, the focus in the analysis is on the expectations of the shareholders of the enterprise under review.[15] In this case, that is SJW Corp. The record shows that SJW Corp.'s other water utility, San Jose Water Company, recently agreed to a 9.99% return on equity in California,[16] where its current return on equity is 10.2%[17]. CLWSC's ability to attract capital from SJW Corp will not be adversely affected if its return on equity is set at 10.88%, when the return available on most relevant alternative investments of comparable risk is 9.99%.[18]

Contrary to CLWSC's arguments in its exceptions, the worksheet is a market-based approach. The worksheet uses Baa bond rate as the starting point of the calculation with various adjustments to reflect differences in risk faced by different utilities. Consistent use of the worksheet by the Executive Director, and the Commission, will allow for utilities and ratepayers to know the starting point for discussions regarding the appropriate return to apply. The Commission should not grant CLWSC's exception on this issue.

B. Rate Base Exceptions

CLWSC excepts to the PFD's recommendation to set rate base as recommended by the Executive Director. CLWSC claims that the amount is based on "misinformation" that the Executive Director "mistakenly" supplied in its record evidence. Unfortunately for CLWSC, this issue was not litigated in the contested case below, and it is too late to try to fix this now. As the record stands, there is no evidence that the Executive Director's recommendation was mistakenly supplied.

In his closing arguments, the Executive Director attempted, for the first time, to raise an issue about how he determined CLWSC's rate base, and the Executive Director attached schedules to its pleading purporting to fix the problem. **CLWSC objected to the argument and the schedules** as being too late. The ALJs, in an abundance of caution, agreed with CLWSC and excluded the argument and the schedules. It is too late now for CLWSC to reverse its prior position. CLWSC objected and the parties and the ALJs acted in reliance on that objection as illustrated by the fact that the Executive Director did not provide exceptions on this issue. It

[15] Tr. p. 818.
[16] CEWR Ex. 41; Tr. p. 124.
[17] CEWR Ex. 42, Request for Admission 19; Tr. p. 124/25;
[18] Mr. Scheig testifies that SJW is not an appropriate alternative investment because of it is in a different regulatory environment. Tr. p. 933. Yet, Mr. Scheig admits that the comparables in his CAPM study included SJW Corp and that he did not review the regulatory environment of these comparables. Tr. p. 933-935.

would be unfair and prejudicial at this stage of the proceeding to allow CLWSC to withdraw its objection. CLWSC must abide by the consequences of its objections.

If the schedules are to be admitted into evidence, CEWR is entitled to cross-examine the Executive Director's witness regarding the schedules. Consequently, if the record is reopened to allow the Executive Director's schedules to be subject to cross-examination and admission into the record, CEWR respectfully offers the schedules it attached to its closing arguments into evidence, and CEWR will make its witness available for cross-examination to explain the schedules.

1. Original Cost and Use of Trending Study

CEWR agrees with CLWSC that there is only one original cost to use for the invested capital used to determine a utility's return. CEWR asserts that original cost, in this context, is the price paid for the assets by the first utility placing the assets into service. In this case, the original cost for the assets owned by the WSC is the price paid for the assets by CLWSC, the first "utility"[19] placing the assets into utility service. This was CEWR's position at the hearing, but the ALJs rejected this argument preferring instead to try to determine the price paid by the WSC for the assets.

CLWSC had the burden of proving the amount paid by the WSC for the assets. The ALJs found that CLWSC failed to meet its burden of proof on this issue.[20] By insisting that trended costs are original costs, CLWSC is ***confusing the value*** of the assets at the time of construction (which can be estimated using a trending study) ***with the actual price paid*** by the WSC for the assets (original cost). The evidence unquestionably shows that more than $13 million in assets were given to the WSC. The price paid by the WSC for those assets was zero dollars ($0.00). The original cost of those contributed assets was zero, and as acknowledged by CLWSC, if the original cost of the assets was zero, the original cost remains zero for the life of these assets.

As CEWR has consistently argued in this case, using a trending study to establish original cost is an exceptional form of relief that the Commission should only use when no alternative methodology exists to establish original cost and when exclusion of the assets from rate base would harm the financial integrity of the utility. The utility has the burden of proof on

[19] By definition, a WSC is not a "utility" under Texas Water Code § 13.002(23).
[20] PFD, p. 54.

original cost. **If the utility lacks the records to establish the amount it paid for an asset, that asset should be excluded from rate base. Period.** Over the years, the Commission has been faced with exceptional situations where incompetent small utilities failed to maintain any asset purchase records, and these utilities lacked sufficient revenue through rates to continue to provide service. In those situations, the Commission properly allowed invested capital to be determined using a trending study. This ensured that the ratepayers would continue to receive service. The use of trending studies should not be condoned by the Commission for establishing original cost of assets when accounting records exist that clearly establish the value of those assets, nor should they be used to establish original cost unless the financial integrity of the utility is at risk.

a. Booked Costs Are Not Original Cost Estimates

CLWSC's position that booked costs are not original cost estimates is absurd. The value of assets shown on utility books is the most reliable source of original cost information. There is no reason to believe that the WSC's assets were not booked at the time they were acquired and put into use. In fact, CLWSC relies on the booked costs of the "TWDB assets" in establishing the original cost of those assets acquired by the WSC.

b. Prior CLWSC Rate Cases Do Justify Rejection of Trending

CLWSC, on two prior occasions, represented the original cost of these assets to be the booked cost of the assets. In those applications, Mr. Thomas Hodge, CLWSC's General Manager, swore under oath that "all statements made and the matters set forth" in the applications were "true and correct."[21] Based on Mr. Hodge's oath, CLWSC should be bound by the statements in those applications. The fact that the applications did not go to hearing does not change the nature of Mr. Hodge's representations. The Executive Director, the ratepayers, the ALJs and the Commission should be entitled to rely on Mr. Hodge's oath, especially when CLWSC wants to contradict that oath to its advantage.

c. CLWSC's Trending Study Is the Least Reliable Estimate of Original Cost

The ALJs articulate clear reasons for concluding that CLWSC's trending study is not sufficiently reliable to be used to determine original cost in lieu of using CLWSC own accounting records. The ALJs heard all of the evidence and are the only triers-of-fact who can

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[21] CLWSC Ex. 5 (CLWSC000485 & CLWSC000499) and CLWSC Ex. 6 (CLWSC000850 & 000863).

rule on whether the Commission should accept CLWSC's clearly biased study. The fact that the Commission has accepted other trending studies for other utilities does not prove that the study performed by CLWSC is sufficiently reliable, which it is not. The amount of subjectivity and imprecision in CLWSC trending study make it of no value for establishing original cost.

CLWSC makes the claim that book costs are less reliable than trended costs. This claim is unsupportable. CLWSC is claiming that amounts contemporaneously entered into financial accounting records are less reliable than amounts made up by engineers well after the fact. CLWSC relies on the book costs to justify the original cost of the TWDB assets. Surprisingly, however, CLWSC relies on its own book costs to justify the original cost of the assets it constructed. CLWSC offers no explanation as to why its books should be ignored in some cases and fully embraced in others.

Additionally, as discussed previously, a trending study does not determine the original cost of assets. Rather, a trending study provides an estimate of the construction cost of an asset at the time of construction. It provides no information about the price paid for the asset by the utility, which is particularly important if someone other than the utility constructed the asset, such as by a developer who subsequently gave the assets to the utility.

2. Contributions in Aid of Construction (CIAC)

CLWSC excepts to the ALJs finding that there is CIAC related to the assets acquired from the WSC. CLWSC's arguments rehash the arguments it made at hearing, which were rejected by the ALJs. The Commission should disregard CLWSC's exceptions.

CLWSC argues that contributions should be ignored because the WSC did not maintain a balance sheet account for contributed capital. The different accounting approach used by the WSC cannot be a basis to not adjust for contributions. It merely adds to the problem of determining the amount of contributions. Both a WSC and an IOU would record the contributions as revenue; the difference being that an IOU would offset that with a balance sheet entry for contributions, while the WSC recorded the offset as member's equity, which is also a balance sheet entry.[22] The WSC recorded the contributions as member's equity because there was no reason to record them as anything else. The WSC's rates were not set based on its ratebase or invested capital. How the contributions were recorded in the balance sheet should make no difference on CLWSC's burden to properly account for contributions (properly

[22] Tr. p. 1328.

determine original cost).[23] Because of the problems associated with determining the amount of contributions (and to be fair to CLWSC), CEWR recommended that the original cost of these assets be determined using the purchase price paid for the assets by CLWSC.

CLWSC also argues that the Commission should be bound by the representations made in the STM filed to authorize CLWSC's purchase of the assets. The STM, which contained sworn verifications, did not indicate any CIAC. Rather than proving that the WSC had no CIAC, the STM stands as a basis to conclude that the management of both CLWSC and the WSC purposefully misrepresented this fact under oath. CLWSC knew that the CIAC was present based on the letter from Dr. Gebhard[24] but simply chose not to inform the Commission. Moreover, as recognized by the ALJs, the STM application was to prove that the applicant had the financial, managerial, and technical capabilities to provide service; it was not to establish rate base or CIAC adjustments.

The ALJs properly determined that CLWSC's rate base includes CIAC, and that by including such property, the ALJs are asking the Commission to force the ratepayers to pay twice for the same property – once through their purchases of lots and direct contributions to the utility and a second time through CLWSC's rates. CEWR requests that the Commission reverse the ALJs decision to grant a "good cause" exception, which makes this gouging possible.

3. Negative Acquisition Adjustment

CLWSC agrees with the ALJs rejection of the Executive Director's proposed negative acquisition adjustment and states that the removal of cost free capital is not authorized by the Water Code or by any decision of any regulatory body. CLWSC is wrong again. CEWR would like to note that CLWSC's statement is an attempt to misdirect the Commission from what is really important here – the price paid for the assets by CLWSC. Under Texas law, a utility may only earn a return on capital that the utility actually invests in its system.[25] Invested capital is tied to original cost, which is defined as the amount paid by the utility for the assets. If a utility pays nothing for a particular asset (no matter how much the asset might be worth), the original cost of the asset is zero. There is no need for the Commission to adopt a rule authorizing the

[23] Tex. Water Code §13.131(a) ("Every utility is required to keep and render its books, accounts, records, and memorandum accurately and faithfully.").
[24] CLWSC Ex. 39 (Attachment A to CEWR's Exceptions).
[25] Tex. Water Code §13.185.

removal of cost free capital for rate base because there is no authorization for utilities to include cost free capital in rate base in the first place.

4. Customer Deposit Issue

CEWR has no objections to the ALJs' recommendation on this issue.

5. Accumulated Deferred Federal Income Tax Issue

The Commission's rule (30 TAC §291.31(c)(3)(A)(i)) on this matter is clear – accumulated reserve for deferred federal income taxes may not be included in a utility's rate base. CLWSC appears to be arguing that the rule has the contrary meaning – that the rule allows for the removal of ADFIT only on a showing of good cause. The proper reading of the rule, and the reading of the rule used by the ALJs in this case, is that the rule required removal of ADFIT unless the utility demonstrates good cause to include ADFIT in invested capital. To the extent that the Commission found otherwise in *In re Application of Southern Water Corporation* (SOAH Docket Nos. 582-09-2068 and 582-09-2069), the Commission was in error, and the Commission should take this opportunity to clarify the meaning of its rule.

6. Unverified Assets

CLWSC could not demonstrate that certain assets were in use during the test year. The ALJs excluded these assets from rate base. CLWSC offers nothing new in its exceptions to demonstrate that the assets were used during the test year. The assets should be excluded. CLWSC states that Mr. Thomas A. Hodge rebutted the Executive Director's testimony on this issue. That statement is incorrect. Nowhere in the testimony referenced by CLWSC does Mr. Hodge's respond to the Executive Director's claims.

7. Intangible Assets

In the PFD, the ALJs recommend the removal of certain costs from rate base because the costs (such as costs associated with long-term planning) were better described as expenses rather than investments, and amortized the costs over a period of time because they were non-recurring expenses. CLWSC offers nothing in its exceptions to counter the ALJs' determination.

C. Exceptions to Expense Recommendations

1. Corporate Allocations and Related Expenses

Initially, CEWR reasserts its position that all of the allocated corporate expenses should be excluded because they are affiliate transactions, and CLWSC failed to make the required showing under Texas Water Code §13.185(e) to justify allowing the affiliate transaction. The ALJs make the necessary findings under §13.085(e), but those findings are based on the allocation methodology advocated by the Executive Director, not the methodology advocated by CLWSC. CEWR's position is that it was CLWSC's burden to justify the affiliate transactions, not the Executive Director's, and that the expenses should be excluded entirely because CLWSC failed to meet its burden of proof.

In its exceptions, CLWSC argues that its time-based allocation is superior to the connection-based allocation used by the Executive Director and the ALJs. CLWSC, however, does not acknowledge that it refused to provide the underlying time sheets or other documentation used in its time studies. Without such documentation, neither the parties nor the ALJs could determine the reasonableness of the time-based allocation methodology, nor could the parties determine whether the methodology was applied consistently across other affiliates. The only other testimony regarding a reasonable allocation methodology was from the Executive Director. Based on the record, the Commission has two choices, approve the methodology recommended in the PFD, or exclude all of the expense on the basis that CLWSC failed to meet its heightened burden of proof on this issue.

2. CLWSC Employee Benefits

The ALJs determined that $81,376 in employee benefits were not reasonable and necessary expenses that should be borne by CLWSC's ratepayers. These benefits were in addition to CLWSC's generous salaries and other substantial benefits provided to the employees, including paid time off, deferred compensation plans, overtime meals and pay, employee education, as well as retirement contributions, medical and dental insurance. CLWSC provided no evidence that the additional benefits of a Health Savings Account and "free" water, were necessary to attract and retain its work force. Without such a showing, these additional benefits should be excluded from CLWSC's revenue requirements. CLWSC is still free to offer these benefits (or other benefits like free lunches or cars), but the cost of those benefits will be borne by the shareholders and not the ratepayers.

3. Bad Debt/Uncollectible Accounts Expense

In the PFD, the ALJs recommend disallowance of CLWSC's known and measurable adjustment for bad debt. The test year amount for bad debt (which is an accounting entry rather than an actual out-of-pocket expense) was $69,003.[26] CLWSC's known and measurable adjustment to this amount was $47,736 (a 70% adjustment). Mr. Hodge offered the only testimony regarding "Office Expenses" (the accounting location of the expense), and that testimony said nothing about Uncollectible Accounts Expense or the reasonableness of any known and measurable changes, thereto.[27] He offered no justification for a 70% adjustment to the test year expense.

The ALJs properly found that CLWSC did not provide any testimony to support such an enormous increase over the test-year expense. CLWSC asserts in its exceptions that the adjustment is based on known and measurable volume adjustments.[28] Nothing in the record indicates that CLWSC has known and measurable volume increases of 70%.[29] This amount is certainly not shown in the billing determinants (volumes) used to determine rates.

As pointed out by CEWR and the Executive Director in their exceptions, the PFD fails to actually remove the known and measurable amount from the recommended expenses allowed. It is interesting to note that CLWSC does not bother to point this error out to the Commission.

4. Directors' Fees

CLWSC offered no evidence that the fees paid to the directors of CLWSC are reasonable and necessary to provision of retail water service or that they provide any benefit to the ratepayers of the utility. No Evidence. The Executive Director affirmatively testified that the fees are not reasonable or necessary.[30] Based on the record, the fees must be disallowed. CLWSC's claims in its exceptions that the services are not duplicative is merely the speculation of counsel.

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[26] PFD, p. 69.
[27] Hodge Direct, p. 36-37.
[28] CLWSC Exceptions, p. 47.
[29] 69% = 47,736/69,003.
[30] ED Ex. DL-01 Supplement, p. 2.

5. Rate Case Expenses Included in Rates

At the hearing on rate case expenses, CLWSC admitted that it was attempting to double recover for the rate case expenses it included in its application.[31] At the hearing, CLWSC witness, Mark Zeppa, affirmatively stated that to avoid double dipping, the costs included in the application would be taken out of revenue requirement and recovered through a rate case expense surcharge, and that this was what the "Commission has consistently done in every rate case for the last ten years."[32] Understandably, the ALJs were concerned about CLWSC's actions and directed CLWSC to remove the duplicative rate case expenses from revenue requirement in accordance with Mr. Zeppa's testimony.

In the exceptions, CLWSC wants to change its mind and leave the expense in revenue requirements because it is concerned that it might not be allowed to recover these costs because, if it is removed, CLWSC may not be unable to satisfy the Commission's 51% rule. This is a truly amazing argument. Commission rule, 30 TAC §291.28(f) states that a utility may not recover rate case expenses, including expenses associated with the preparation of the application, unless the rate approved by the Commission is greater than 51% of the rate proposed by the utility. The rule does not provide any additional protection for rate case expenses that the utility rolls into the application. To the extent that the utility includes rate case expenses in its proposed rates, the utility bears the risk associated with such inflation of its rates.

Mr. Zeppa clearly states that these expenses should be removed from revenue requirements in this situation based on years of consistent decisions by the Commission. CLWSC now wants special treatment (another "good cause" exception) from the Commission's rules and practices. CEWR requests that the Commission reject CLWSC's attempt to play games to unjustly recover additional costs from the ratepayers.

6. Normalized Expense Adjustments

The Water Code specifies that rates be based on a historic test year.[33] Unless a utility can clearly demonstrate that actual test year data is not representative, the Commission should not allow a utility to adjust test year data. The ALJs found that CLWSC did not demonstrate that the actual test year volumes should be adjusted ("normalized"). CLWSC failed to meet its burden to allow for the exceptional relief it sought. CLWSC had only two years worth of data. As noted

[31] Zeppa Cross Examination, Tr. p. 1615-1616.
[32] *Id.*
[33] Tex. Water Code §13.002(22).

by CLWSC's expert, Mr. Loy, most jurisdictions do not allow normalization on two years of data –they require 10 to 30 years of data.[34]

D. Exceptions to Depreciation Expense Recommendation

CLWSC's depreciation expense must be adjusted to reflect the adjustments in rate base.

E. Exceptions to Federal Income Tax Recommendation

In the PFD, the ALJs did not make a federal income tax recommendation but requested the Executive Director to recalculate the expense using the recommended adjustments in the PFD. CLWSC could have chosen to offer its own recalculation but has chosen not to do so.

F. Exceptions to Other Taxes

The recommended adjustments in the PFD should be accepted by the Commission.

G. Exceptions to the Rate Collection True-up Recommendation

CLWSC provided notice to its ratepayers of two separate and distinct changes in rates. The first change (Phase 1) had an effective date of October 27, 2010. CLWSC has been charging that rate since that date. The second change (Phase 2) had an effective date of March 15, 2011. CLWSC clearly stated in its notice that it would not charge Phase 2 rates until March 15, 2011, at the earliest.[35] CLWSC is not entitled to an effective date for its rate change earlier than the effective date provided in its notice to its ratepayers.[36]

CLWSC argues that the currently charged rate is an interim rate, and that any changes in the final rate should relate back to October 27, 2010. The error in CLWSC's argument is that the current rate is "interim" only with regard to the Phase 2 rates. This current rate was the actual rate noticed and charged by CLWSC between October 27, 2010, and March 15, 2011. Again, this is just another example of the unnecessary level of complication relating to CLWSC's rate change request.

H. Exceptions to Rate Design Recommendations.

No reply necessary.

I. Exceptions to Summary of PFD Recommendations

No reply necessary.

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[34] Tr. p. 690.
[35] PFD, p. 90-91.
[36] Tex. Water Code §13.187(a) ("new rates may not apply to service received before the effective date of the new rates").

J. Regulatory Approvals

No reply necessary.

K. Exceptions to PFD Rate Case Expense Recommendations

Apparently, CLWSC believes that it is entitled to spend however much it wants in the furtherance of its grossly inflated rate request and recover those costs from the ratepayers. This is not surprising given that Texas utilities, including CLWSC, use the ominous threat of ludicrous rate case expenses as a means to neutralize review and opposition to rate change requests. Additionally, utilities routinely use the threat of rate case expenses to intimidate the Executive Director's staff to acquiesce to requests they might otherwise question. While CEWR believes that CLWSC is not entitled to any rate case expenses because the final rates approved by the Commission will be less than 51% of the amount CLWSC sought in its application, it will briefly reply to CLWSC's exceptions.

1. The "Public Interest" and Reasonable and Necessary Attorneys' Fees

CLWSC takes the position that only lawyers may testify as to the reasonableness of legal expenses. Such a position makes not sense in the context of determining whether rate case expenses were reasonable and necessary. Does this also mean that only rate consultants, such as CLWSC witness Mr. Loy, can testify as to the reasonableness of rate consultant expenses? The issue for the Commission is not whether Mr. Terrill or Mr. Zeppa have violated their professional responsibilities by billing their client for the level of service provided. Rather, the issue for the Commission is whether CLWSC spent a reasonable amount in preparing and prosecuting its rate case. It is not legal malpractice to research every possible issue, but that conclusion does not mean that it would be reasonable and necessary to have the ratepayers pay for such excessive behavior.

To achieve perfection in rates, a utility could spend a great deal of money hiring expensive consultants and giving those consultants free reign in deciding how much effort to spend reviewing records and developing complicated models and methodologies to include in the rate application. The fact that attorneys rather than rate consultants incurred such expenses is not material. Such expenses, however, should not be shifted to the ratepayers unless the expenses are reasonable and necessary, and in the public interest. The determination of reasonableness needs to be made from the perspective of the utility (and ultimately its ratepayers) – not the perspective of the attorney.

2. Order No. 8

CEWR invites the Commission to read the ALJs' discussion of the Order No. 8 issue very carefully. Order No. 8 directed CLWSC to identify the changes it had made in the application as part of its prefiled testimony. The expenses were unnecessary because CLWSC should have been ready to proceed to hearing based on its application as filed. The Commission's rules clearly state that a utility filing a rate change application "shall be prepared to go forward at a hearing on all data" submitted as part of its application.[37] The rule does not allow the utility to continuously revise its application throughout the review process, such as was done by CLWSC and for which it wants to recover rate case expenses.

The adjustments recommended by the ALJs are reasonable given the timing of CLWSC's changes to its underlying data, particularly the "infamous Attachment 5."[38] CEWR requested an electronic copy of Attachment 5 as part of its first discovery request, which was filed on January 13, 2011.[39] CLWSC objected to providing the attachment, but was ordered to produce the electronic version by Order No. 4, which was signed on April 7, 2011. CLWSC did not actually provide the electronic version to CEWR until April 27, 2011.[40] What CLWSC produced was Attachment 5 as prepared for the application. CEWR's consultant then dove into reviewing the Attachment, assuming that this was the final version of the Attachment because CEWR's testimony was due on June 10, 2011.[41] On May 20, 2011, CLWSC filed its direct testimony (after getting a one week extension). This testimony contained wildly different asset values than contained in the application, and different from the values contained in Attachment 5, which had been finally produced only 24 days before. CEWR immediately objected to these changes and to CLWSC's failure to provide an electronic version of the revised Attachment 5. In response to CEWR's attempts to obtain an electronic version of the revised Attachment 5, CLWSC stated, "No such document exists."[42] CLWSC maintained this charade in subsequent filings,[43] even though CLWSC knew that the underlying information from the application had been changed,

[37] 30 TAC § 291.25(b).
[38] Loy Cross, Tr. p. 1702-1703.
[39] CEWR's Motion to Compel on its First Discovery Requests to Canyon Lake (March 28, 2011).
[40] CEWR's Motion to Strike Amendments to Application and Motion to Abate Pending Resolution of this Motion (May 31, 2011).
[41] Order No. 1.
[42] CLWSC's Response to CEWR's Motion to Strike Amendments to Application and Motion to Abate Pending Resolution, p. 3 (June 7, 2011).
[43] CLWSC's Motion to Amend Rate Change Application and Brief, p. 5 (June 24, 2011).

that the changes existing in spreadsheet form, and that CLWSC had an obligation to provide the information to CEWR. The ALJs agreed with CEWR and, as part of Order No. 8, directed CLWSC to provide the revised Attachment 5.

CLWSC wants to portray Order No. 8 as an order that deviated from normal. According to CLWSC, applications are changed all the time (even though these changes are contrary to the express dictates of 30 TAC § 291.25(b)). To the extent that the Order No. 8 is abnormal, it was a proper response to CLWSC's abnormal behavior. Order No. 8 was an attempt to get CLWSC to ameliorate the harm to CEWR that resulted from the discovery games being played by CLWSC. CLWSC knew that the electronic version of Attachment 5 that it finally produced had been "amended" before they produced the un-amended version. Then they refused to produce the amended version. All of this was done to frustrate CEWR's review and testimony preparation, increasing CEWR's expenses, which are funded from volunteer efforts and voluntary donations from ratepayers throughout the CLWSC service area. Order No. 8 directed CLWSC to reduce the damage they had done. Accordingly, CLWSC should recover no rate case expenses for responding to Order No. 8.

CEWR believes that actual rate case expenses associated with CLWSC negligently (or intentionally) frustrating CEWR's ability to prepare for hearing by changing the application, and by resisting discovery, far exceeds the amount suggested in Exhibit ED 8. CEWR, however, cannot thoroughly differentiate these costs from CLWSC's other (arguably legitimate) costs contained in the invoices of CLWSC's various consultants. Even with unlimited time and resources, which it does not have, CEWR would never be able to affirmatively demonstrate with precision the amount of unnecessary time spent by CLWSC on this effort. Even at the hearing on rate case expenses, CLWSC's position was that they had not changed the application, and therefore, could not specifically identify any costs associated with changing the application.[44]

The Commission needs to send a message to utilities to treat their customers fairly during rate case proceedings. The utility always has the advantage of knowing the facts; the ratepayers know only those facts the utility chooses to share, either voluntarily or through discovery. As long as utilities feel free to abuse the process for providing information, they will always have an unfair advantage in any rate proceeding. The Commission should make it clear that it will

[44] Terrill Cross, Tr. 1542, 1546,

tolerate no abuse of the process for disseminating information relating to rate changes. The Commission should disallow the expenses as recommended by the ALJs.

3. Deposition and Hearing Transcription Costs

CEWR and CLWSC agreed on this issue at hearing and on the recommendations in the PFD.

4. Attorney's Fees for Closing Arguments

The ALJs were right to reduce rate case expenses related to closing arguments by $16,354.69 for unnecessary costs incurred by CLWSC's attorneys. The issues involved in this case (as presented by CLWSC) were not that complex (other than to the extent the CLWSC unnecessarily made them complex). CLWSC's closing argument, basically requested exactly what it asked for in its prefiled testimony, without addressing the majority of the arguments raised by CEWR. This was work CLWSC previously performed when compiling its case. CLWSC did not perform much extra work in compiling its closing arguments. CEWR briefed the same issues as CLWSC, and did not run up $40,000 in expenses. The time and money spent by CLWSC in preparing closing arguments was not reasonable when compared to the contents of the closing arguments. The ALJs relied upon the testimony of the Executive Director's witness, who has substantial experience regarding contested rate cases. The ALJs are entitled to give great weight to the Executive Director's testimony.

Rate case attorneys, even those representing utilities, must take some care to control costs. Not every legal issue has to be briefed. Not every inflated expense has to be defended. CLWSC appears to have directed its attorneys to fight every issue (no matter how small or inappropriate) to the end using all available resources. While such a fight may be in the best interests of CLWSC's shareholders, who benefit from the rates being set too high, such a fight is not in the best interests of CLWSC's ratepayers. CEWR asks the Commission to take this opportunity to remind the utilities in this state that they have an obligation to control costs, even rate case expenses.

5. Consultant Expenses for Closing Argument

The ALJs were right to reduce rate case expenses related to closing arguments by $9,067.50 for unnecessary costs incurred by CLWSC's attorneys. The issues involved in this case (as presented by CLWSC) were not that complex. CLWSC's closing argument, basically requested exactly what it asked for in its prefiled testimony, without addressing the majority of the arguments raised by CEWR. This was work CLWSC previously performed when compiling its case. CLWSC did not perform much extra work in compiling its closing arguments. CEWR briefed the same issues as CLWSC, and did not run up $40,000 in expenses. The time and money spent by CLWSC in preparing closing arguments was not reasonable when compared to the contents of the closing arguments. The ALJs relied upon the testimony of the Executive Director's witness, who has substantial experience regarding contested rate cases. The ALJs are entitled to give great weight to the Executive Director's testimony.

The ALJs relied upon the testimony of the Executive Director's witness, who has substantial experience regarding contested rate cases. The ALJs are entitled to give great weight to the Executive Director's testimony. Additionally, as the ALJs note, even though the Executive Director and CEWR attached schedules to their closing arguments, CLWSC included very little substantive analysis in its response.[45] CLWSC's "review" of the Executive Director's schedules also appears to have been substantially incomplete, given that CLWSC objected to the schedules during the hearing, but wants the schedules admitted now.

6. Rate of Return Expert Expenses

The ALJs properly recommend the disallowance of $45,213.75 in expenses related to CLWSC's rate of return expert Mr. Scheig. The amount recommended in the PFD covers the amount billed by Mr. Scheig for preparing his testimony as part of the application and for the brief time he was needed at the hearing. All other expenses incurred by Mr. Scheig were unnecessary, as determined by the ALJs who participated in the hearing.

Contrary to CLWSC's arguments, the ALJs do fully explain the basis for their recommended disallowance. The ALJs describe Mr. Scheig's invoices as lacking sufficient detail to determine what CLWSC purchased (and that such lack of detail was not remedied during testimony).[46] The ALJs describe some of Mr. Scheig's testimony as "erroneous."[47] They note that he charged CLWSC for services, even if those services were not used.[48] They also take issue with his unnecessary trips to Austin and the high hotel costs he incurred. They describe Mr. Scheig's testimony as "not credible based on his inability to recall needed details and his

[45] PFD, p. 108.
[46] PFD, p. 109-111.
[47] *Id.*
[48] Id.

erroneous testimony."[49] The ALJs conclude that little weight should be given to Mr. Scheig's testimony and that CLWSC failed to meet its burden of proof to recover these costs. The Commission should agree with the ALJs on this issue.

7. Attorneys at Depositions and the Hearing

While CEWR did not except to the ALJs decision to allow CLWSC to recover for overstaffing attorneys at deposition and at the hearing, CEWR continues to believe that the Commission needs to send a clear message to the regulated utilities that the Commission will monitor rate case expenses closely and will demand that utilities take reasonable efforts to control these costs.

8. Estimates for Rate Case Expense Hearing

CLWSC wants to recover expenses relating to the cost of recovering expenses. At some point, this cycle has to end. While CEWR did not except to the ALJs' decision, CEWR believes that it is improper to allow CLWSC to include expenses based on estimated costs of such expenses.

9. Exceptions and Agendas

CLWSC seeks to recover for future rate case expenses based on its estimation of the amounts necessary to brief, what was then an unwritten PFD. CEWR believes that CLWSC should recover nothing for expenses it has yet to incur. Based on the length of CLWSC's exceptions, CLWSC may well have spent $50,000 on Mr. Terrill's services, but that does not mean that all of Mr. Terrill's billings were reasonable, necessary and in the public interest. Moreover, CEWR has not had the opportunity to cross-examine Mr. Terrill to explore exactly the reasonableness and necessity of his work and billings. Awarding rate case expenses based on pure estimation is improper.

10. Other Rate Case Expense Recommendations

CLWSC agrees that it should not be allowed to recover $8 spent by Mr. Thomas Hodge on parking so that he could attend a hearing of a Legislative committee during the 2011 session. Although this amount is so small as to be immaterial, it reflects CLWSC's approach in preparing and prosecuting its rate case. The Texas Water Code unambiguously states: "the regulatory

[49] *Id.*

authority may not include for ratemaking purposes legislative advocacy expenses."[50] Nevertheless, CLWSC sought to recover such expenses. At hearing, CLWSC attempted to argue that this was not a legislative advocacy expense because Mr. Hodge was merely participating in an "educational session" at the Capitol.[51] Of course, it cost CEWR more than $8 to discover and to recommend disallowance of this clearly improper expense.

11. Exceptions to Rate Case Expense Summary

The summary contained in the PFD is accurate and should not be modified as argued by CLWSC.

L. CLWSC's Ability to Recover Rate Case Expenses

CLWSC asks the Commission to ignore its rules, ignore sound public policy, ignore the scope of overreaching associated with this application, and allow CLWSC to recover its excessive rate case expenses even if fails to satisfy the Commission's 51% rule (30 TAC §291.28(8)). CLWSC argues that the Commission has the discretion to award rate case expenses even if the final rates are less than 51% of the proposed rates because of the word "may." CLWSC's interpretation is mistaken. Under the rule the Commission is barred from awarding any rate case expenses if final rates are less than 51% of proposed rates. The term used in the rule is "may not recover," which is an absolute prohibition.[52] No matter how much of an increase is finally awarded, however, the Commission has the discretion not to award rate case expenses, if the Commission finds good cause, such as abusive conduct by the applicant. CEWR would suggest that if the final rates end up being 52% of the proposed rates, that CLWSC only recover 52% of its rate case expenses, at most.

CLWSC suggests that it should be allowed to recover rate case expenses, despite its failure to support its proposed rates, because of its dire need for a rate case, the unique and unprecedented issues, and "good faith" nature of its application. CEWR disputes each of these claims. CLWSC will get a rate increase. No one has disputed the need for an increase. Even CEWR's recommendations in its closing arguments would provide for an increase. CLWSC should not be rewarded for overreaching in its rate application. The issues in this case were unprecedented because CLWSC decided to push every issue to an extreme position in an effort

[50] Tex. Water Code § 13.185(h)(1).
[51] Tr. p. 1755-1756.
[52] Tex. Gov't Code §311.016(5) ("May not" imposes a prohibition and is synonymous with "shall not.")

to maximize its return. CLWSC was provided with many opportunities to settle throughout this proceeding. CLWSC chose not to take advantage of these opportunities.

Finally, CLWSC attacks the methodology to be used to determine compliance with the 51% rule. CLWSC had the opportunity to offer its own methodology at the hearing, but it chose not do to so. The only evidence in the record as to the "proper" methodology and numbers to use comes from the Executive Director. No evidence supports the methodology recommended by CLWSC in its exceptions.

M. Proposed Order, Findings of Fact, and Conclusions of Law

CLWSC objects to the entirety of the proposed order, findings and conclusions contained in the PFD and offers the proposed findings and conclusions it submitted in its closing arguments. The Commission should reject CLWSC's objection on this point. The Commission should adopt the ALJs recommended findings, as modified by CEWR's exceptions.

II. Replies to the Executive Director's Exceptions

Generally, CEWR has no objection to the exceptions filed by the Executive Director. For the most part, CEWR and the Executive Director are in agreement on the underlying principles that should control the Commission's decision in this matter. Any disagreement between the two parties is in the details of the decision. CEWR will provide brief replies only as necessary.

A. Cost Free Capital Should be Removed

CEWR and the Executive Director agree that cost free capital should be removed from CLWSC invested capital because that is the law and to prevent CLWSC from obtaining a windfall.[53] The Executive Director argues that the adjustment should take the form of a negative acquisition adjustment. CEWR argues that the adjustment should take the form of only including purchase price in invested capital or by removing CIAC from rate base. While CEWR believes that the Executive Director's approach goes far enough, CEWR would not object if the Commissioners adopted the Executive Director's approach. Such an approach would approximate the amount actually paid by CLWSC for the assets and would provide a mechanism for reviewing other acquisitions made by CLWSC.

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[53] Windfall is defined as "a profit . . . not caused by the recipient." Blacks Law Dictionary (7th Ed. 1999).

B. Rate Design

The Executive Director states that the PFD does not clarify whether the ALJs wanted a tiered rate. CEWR took no position on the issue of tiered rates at the hearing, and has no objection to the Executive Director's tiers as provided on page 2 of the Executive Director's Attachment C. CEWR does not object to the rates as calculated by the Executive Director on page 2 of Attachment C, which are the rates based on the cost-free capital being removed from CLWSC's rate base.

C. Refunds

The Executive Director recommends that the Commission order CLWSC to determine the amount of refunds owed to the customers for rates charged since October 27, 2010. CEWR does not object to having CLWSC determining this amount, provided that CEWR is provided with an opportunity to comment on CLWSC's determination.

CONCLUSION AND PRAYER

After considering the foregoing, CEWR respectfully requests that the Commission adopt the ALJ's PFD with the changes suggested in CEWR's exceptions. Alternatively, CEWR respectfully requests that the Commission remand this matter to the ALJs for the limited purpose of determining the appropriate manner to amortize the CIAC found by the ALJs to have been improperly included in CLWSC's invested capital, and to recommend final rates based on the Commission's determinations relating to the other findings in the PFD.

Respectfully submitted,
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CERTIFICATE OF SERVICE

I hereby certify that on this 22nd day of January 2013, a true and correct copy of the foregoing document was sent to the persons listed below in the manner identified.

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